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The collapse of the Soviet style economies has been hailed as a Victory of Capitalism and the simultaneous breakdown of the Communist political regimes has been taken to validate an identification of Capitalism with Democracy. In some circles the view has been put forth that this victory marks the end of History as we have known it. As the events in the Gulf, the fragility of capitalist prosperity, and the irredentist pressures that have been unleashed by the collapse of the Soviet hegemony in Eastern Europe show History does not end: like the Mississippi in song "...it just keeps rollin along."

It is much too soon to celebrate the victory of Capitalism as we know it. The financial structure in the

United States and Japan is much too fragile for comfort. It is forgotten that a sharp drop in asset values, investment and the cash flows that validate private debt can happen. Inasmuch as more and more of the income of business, household and, in the United States, government units are committed to the validation of debts, the maintenance of aggregate demand that is adequate to maintain profits, wages and taxes at a high enough level to satisfy payment commitments requires that the debt financing of investemnt, consumption and government continue on a high level. The situation of Capitalism in the 1990's might be likened to that of the Fiddler on the Roof: the prosperity is precarious, one slip and disaster may rule.

There is no doubt that Soviet style Command Socialism broke down. But this form of Socialism is not the only possible form. The characteristic of the Soviet model is that it never allowed the preferences and wishes of the people to affect the outputs that were produced. Effective signals in the Stalin model of Socialism went from the top to the bottom, never from the bottom, from the populace, to the center, to those who made the decisions about the what and the how of production. There exist alternative theoretical models of Socialism in which Consumer Sovereignty reigns to a larger extent than in capitalist economies.

The Stalinist centralized command economy model is not bad when the load that is placed upon the economy is simple:

when bread or tanks is all that need be produced. A command economy worked quite well in the transformation of a simple peasant society into a narrow mass production economy - when steel, concrete and power plants were all that was to be produced: it also works quite well for the production of war goods. Military procurement in the United States and Britain during World War II followed a command economy model.

The command economy model does not work well when the consumption bundle is much expanded from a simple "bread" diet and when industrial processes are ever changing. When people do not live by bread alone, command socialism breaks down. There is some truth in the proposition that the breakdown of the Soviet model command economies was a "Coca Cola" revolution, where "Coca Cola" stands for the broad array of goods we take for granted in Bergamo, not for a simple drink which was debased when caffeine was substituted for the real thing "cocaine".

Even as the Victory of Capitalism was being celebrated, first in Paris, then at the Berlin Wall, and now throughout the expanded west, it became obvious that the dominance of the Unites States in the World Economy had been severely eroded. Furthermore the very prosperity of the west was seriously endangered by the massive losses that major financial institutions were experiencing. The high ratio of payment commitments on debts to cash flows, which are financial flow legacies of the massive financial restructuring of the 1980's, underlay these losses.

Before we go too far in interpreting the failure of Stalin's Socialism as a victory of Capitalism we need to understand

1. that the capitalism we have in "the west" is just one possible type of capitalism,
2. that the successful functioning of capitalist economies is a new thing,
3. that the successful functioning of capitalism is a fragile phenomena and the evidence is mounting that it is also a transitory phenomena and .
4. the financial problems in the United States are such that capitalism's victory over communism mmay quite quickly be followed by a serious recession, i.e. by a failure of capitalism.

In particular the successful capitalism was a big government capitalism with an effective central bank in which a center, the United States, was able to act as an engine for prosperity. The very act of acting as an engine for prosperity created a financially and economically weakened United States. This weakness is now so evident that it is questionable if the United States cam act as the engine which powers international expansion and which by acting in its own self interest succeeds in achieving an end it does not intend to serve, the stabilizing and expansion of the world economy.

It is questionable if the new international financial powers, Germany and Japan, have the will or the underlying economic strength to undertake the task. The costs of unification may be sufficiently open ended that Germany may inadvertently act as an engine of expansion and allow European and American assets to be repatriated.

FAILED CAPITALISM

Capitalism was a failed economic order in 1933. Capitalism is a relatively successful economic order in 1990, even though its success is limited in scope and ever endangered. Even as Capitalism's success in the Common Market and in the United States helped spawn the revolution in Eastern Europe, Capitalism remains a not successful economic form in Argentina, Brazil and Mexico. Furthermore in the United States, Western Europe and Japan the success of capitalism is fragile as 1990 draws to a close.

There are many varieties of capitalism. Capitalisms have shown an ability to adapt and evolve, even though success breeds a reluctance to adapt, to change. There are always exasperating aspects that are often political which are difficult to change. The great failure of the bureaucratic Soviet Socialism was that it was frozen in outputs, in techniques and in organization.

In the United States and Europe the capitalism of 1990 is not the capitalism of 1933. The capitalism that broke down between 1929 and 1933 was much closer to a laissez faire economy than the capitalisms that succeeded in the post war period. One way to characterize the economy of 1929 is that it was a small government capitalist economy in which the central banks were bound by rules that followed from the gold standard, these were rules that limited the ability of the central bank to intervene. For example the total Federal Government spending was about 3% of the gross national product in the United States in 1929. Total Federal Government spending in the United States is in excess of 20% of the gross national product in recent years. The very size of the government sets a floor to how deep a recession the economy can generate.

A dictum of Jefferson's which long guided American thought and action is "That government which governs least is best" This proposition remains true when it comes to individual liberties: government has no business in private relations. Unfortunately this abstract philosophical statement does not apply to the determination of aggregate demand.

Economist now know that the failure of Capitalism in the 1930's was an aggregate demand failure, and that this aggregate demand failure was rooted in the breakdown of the financial system whose dramatic initial stage was the stock market crash of 1929. However 1929 did not take place in a vacuum, over the 1920's the financial system of the United States and of other capitalist countries became increasingly fragile. The message of Keynes in his classic <u>General Theory</u> of 1935 was that both financial fragility and aggregate demand can be controlled by apt public policy. Apt public policy requires a flexible Central Bank and a willingness of an economy that has fiscal independence, in that its liabilities are internationally acceptable so that it can run trade deficits, to run aggregate demand and profit sustaining fiscal deficits.

In the United States the intuitions of the political administration in the early 1930's (The Roosevelt Years) led to the adoption of measures which promoted a robust financial structure and supplemented the demand generated by private investors and consumers with public debt financed spending. The basic reforms of the second New Deal, which were put in place in 1936, before the message of Keynes's General Theory was assimilated by American Economists, freed the Federal Reserve from gold standard constraints and enlarged the spending scope of the Federal Government. These measures were taken before Keynes's explanation of deficit financing and financial reform were necessary. Theory followed what was already practice.

The aggregate demand failures that led to the decline in output during the great depression and which lead to the mild declines that characterizes the more frequent recessions stand in sharp contrast to the breakdown in supply such as characterizes the current "depression" in the Soviet bloc. Economists are able to supply remedies to aggregate demand breakdowns so that a quick recovery of output takes place but they do not have readily available remedies for the organization and motivation breakdowns that characterizes a supply breakdown such as we see in the east.

One dimension of the supply side breakdown is the motivation of workers: how does one get workers to work. The old story of how do you get a donkey to move comes to mind: the question is do you use a carrot or a stick. The affluent economies use the carrots of consumer goods, the poorer economies use the stick of starvation or of physical force. The opening of the Soviet style economies took away the stick, and there were no carrots for the workers.

FINANCIAL FRAGILITY

Capitalism is mainly a financial system which passes the wealth that is embodied in the physical productive plant and machinery of an economy into the wealth of individuals. What the Socialist Countries are learning is that the transition from Socialism to capitalism requires the creation of a financial system. Smith wrote of the Wealth of Nations, but in truth the financial system of Capitalist economies transforms the Wealth of a Nation into the wealth of individuals in the nation.

The striking feature of the capitalisms that developed in the United States and Europe after World War II is that the wealth of individuals in these nations is much more broadly distributed than henceforth. Wealth distribution may not be substantially more equal than hitherto, but a larger portion of the population owns some appreciable claims to the income earned by capital assets than was true in earlier times. For many this wealth is tied up in institutional pension funds, for others the only significant wealth holding is in housing. Nevertheless even as the last years have seen the emergence of a new class of super rich, the breath of participation in wealth holding is a new phenomena. The form of Capitalism in which a significant portion of the economy owns wealth is a peoples capitalism.

However in the United States the wide ownership of assets usually does not take the form of simple ownership. Rather the typical individual owns interests in pension funds, mutual funds, and insurance reserves. These intermediaries issue liabilities owned by the households. They own the liabilities issued by firms that own capital assets.

In its simplest form the financial structure of a capitalist economy takes the income (profits) earned by operating units and distributes them to the individuals in the economy. But this process involves institutions that sit between the households and the nominal owners of the capital assets. These institutions are banks and other fund managers. These institutions are guided by a desire for profits, which the get by earning more on the assets in their portfolios than what they pay on their liabilities: in finance as in other fields profits arise because there is an excess of revenues over costs. But in the process of seeking profits the bankers and other fund managers select assets. One activity that is dependent on being financed by bankers and fund managers is investment. The bankers of a capitalist economy select what is to be financed and therefor they affect the capital development of the economy.

Assets, financial and capital, have prices. Capitalism is characteristically a two price system: one set of prices for current outputs and a second set for capital and financial assets. The combined price system tells us on what terms alternatives are available, however the principles which guide the setting of output and asset prices are quite different. Output prices are the way in which producers recover costs, furthermore they are the carriers of profits. Asset prices are divorced from their costs and represent current views of the incomes they will earn - the cash flows they will generate - and a capitalization rate that represents views of the way the economy is expected to behave and the rational awareness of the imperfections which rule in present knowledge of the future.

Side by side with the financial structure that transforms the income earned by capital into household income in the form of dividends, rents, interest and retained earnings there is a structure of household debts in which some households pay large premiums to have it now: Houses and consumer goods of all kinds can be acquired by debt issues, in the process transferring income to intermediaries which in turn transfer some of their receipts into interest and dividends to other households.

The modern credit card economy carries the household indebtedness phenomena to new heights.

THE THREAT OF OVERINDEBTEDNESS

THE STRUCTURE OF A VIABLE CAPITALISM

the need for big government

big government as a transfer payments system and as a creater of goods and services

one days big government may beciome obsolete in time.